GOVERNOR'S OFFICE OF BUDGET AND PROGRAM PLANNING

# Fiscal Note 2011 Biennium

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| **Bill #** | HB0423 | **Title:** | Revise state land law relating to oil and gas leases |
| **Primary Sponsor:** | Pomnichowski, JP | **Status:** | As Introduced |

- ☐ Significant Local Gov Impact
- ☐ Needs to be included in HB 2
- ☑ Technical Concerns
- ☐ Included in the Executive Budget
- ☑ Significant Long-Term Impacts
- ☐ Dedicated Revenue Form Attached

## FISCAL SUMMARY

| | FY 2010 Difference | FY 2011 Difference | FY 2012 Difference | FY 2013 Difference |
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| **Expenditures:** | | | | |
| General Fund | $0 | $0 | $0 | $0 |
| **Revenue:** | | | | |
| General Fund | $0 | $0 | $0 | $0 |
| **Net Impact-General Fund Balance:** | $0 | $0 | $0 | $0 |

**Description of fiscal impact:**

HB 423 would adjust the annual rental obligation on state oil and gas leases issued after July 1, 2009. If an oil and gas lease had not become productive within the first five years, the annual rental amount would be revised to equal the average royalty or amount received from the top three producing wells in the county or adjacent counties that are drilled into the same formation as the subject lease.

## FISCAL ANALYSIS

**Assumptions:**

1. The Department of Natural Resources and Conservation (DNRC) expects no additional revenue to the state because it is assumed that lessees will drop the lease rather than pay the calculated rental amount that would be due beginning in FY 2015.

**Long-Term Impacts:**

1. Data is not available from which to calculate the lease rental amounts proposed in Section 2. If the calculation could be performed, DNRC would have to calculate annual rental amounts beginning in FY 2015.
2. The department issues an average of 800 new oil and gas leases per year. Annual rentals would therefore have to be calculated on approximately 800 leases each year as they reach the sixth year of their primary term.

3. Leases are issued on a quarterly basis. If the rental calculation could be performed, the processing steps each quarter include: identify leases in year six of primary term, calculate applicable rental rate by county and formation, prepare and mail invoices to 800 lessees, process lease cancellations, protests and appeals, and re-nominations requested by lessees. It is estimated that the department would need 1.00 FTE and associated operating and mailing costs starting in FY 2015 to implement this requirement.

**<u>Technical Notes:</u>**

1. **Section 1, 77-3-401(3):** The lease period for a producing lease continues beyond ten years, for so long as oil and/or gas are produced in paying quantities. The narrative should refer to the "primary term" instead of the lease period. The same correction should be made in Section 2, 77-3-423(5).
2. **Section 2, 77-3-423(5):**
    a. For a non-producing lease, there is no formation to match to the calculated royalty from the top three wells "that are drilled in the same formation." (Page 2, line 16) Therefore, it is impossible to determine the applicable rental that would apply to the lease.
    b. State oil and gas estate ownership constitutes, on average, about 5-10% of a given area. Therefore, on average, 90%-95% of the wells drilled are on private or federal mineral estate. Royalty payments on federal lands are reported to the federal government by lease, and are not available on an individual well basis. Royalty revenue on private lands is taxable but is reported by the individual or company as aggregate revenue received during the tax year, and is not available on a well basis. Wells also frequently generate royalty payments to multiple lease agreements, which can be a combination of state, federal, and private leases. The top three producing wells by formation will likely occur on federal or private leases, or within a spacing unit that will include a combination of state, private, or federal leases. The department would therefore not be able to obtain the information necessary to calculate the royalty or amount received for each well as directed. (Page 2, lines 14 through 16)
    c. If the lease does not become productive until the second half of the primary term, the rental rate would remain at the level calculated per Section 2 for the life of the lease, even though the lease is producing and generating royalties to the state. Rental payments are credited against royalty payments in the current lease year, but the lessee's total rental and royalty payment would remain equal to the average of the top three producing wells even if the well producing on the lease is less productive than the top three producing wells.
    d. Royalty payments are prorated to individual leases on an acreage or other technical basis. For the same well, a small acreage lease is entitled to less royalty revenue than a large acreage lease. If the lease rental could be calculated, the amount would represent 100% of the royalty revenue generated, and would apply equally to all leases, even if a small lease would never be entitled to more than a fraction of the royalty interest associated with a producing well.
    e. The calculation can be interpreted as either the average of the top three producing wells in each county, with the department presumably choosing the highest average from applicable counties; or as the average of the top three producing wells from the aggregate of wells from the county and adjacent counties.
    f. In the event that a lessee retains the lease past year six of the primary term, Section 2 does not specify whether the rental amount calculated for year six remains the same for subsequent lease years or is recalculated each year.
    g. A long-standing statutory provision of state oil and gas leases is the automatic termination of a non-producing lease if the lessee does not pay the rental by the due date. (77-3-423(4), Page 2, lines 9 through 13) Implementation of automatic termination requires a known amount specified in the lease contract that is due on a fixed date each year. This requirement places the entire burden on the lessee to submit rental payments timely each year to continue to hold the lease. As a result, the department does not have to prepare and send invoices to several thousand lessees each

year. The department also does not incur the time and expense of going through an administrative and legal process to close out each lease and clear title when the rental is not timely paid. This provision also is a common lease term in oil and gas leases on private land. It has been upheld by the Montana State Supreme Court. If the rental rate contemplated in Section 2 could be calculated, the amount would be unknown to the lessee until calculated by the department. The department would have to send invoices to all lessees for eligible leases advising of the department's calculated amount due. Since the amount is not predetermined within the lease contract, the lessee must be afforded the opportunity to review and challenge the accuracy of the department's calculation. Automatic lease termination would likely not be recognized by the courts as a reasonable contract provision, and increased administrative and legal time and expense would be anticipated beginning in FY 2015.

3. **Section 3, 77-3-424(1):** Section 3 amends 77-3-424(1) (Page 2, line 20) to make the termination of a lease due to failure of lessee to pay a delay drilling penalty subject to the lease rental calculation provided in Section 2. However, the lease rental calculation does not affect the requirement for payment of a delay drilling penalty as specified in 77-3-424(1), MCA.
4. **Section 4, 77-3-430:** Section 4 limits the land board's ability to enter into spacing units and pooling agreements subject to Montana Board of Oil and Gas Conservation (MBOGC) permitting under 82-11-201 and -102, MCA. This eliminates the ability of the land board to enter state lands into agreements for operation of a pool as a unit pursuant to other MBOGC statutes or voluntary agreements not subject to MBOGC statutes, even though participation in such agreements may be in the best interest of the trust. The limitation proscribed by Section 4 may conflict with the land board's constitutional and fiduciary duty in their management of state school trust lands.
5. **Section 5, 82-11-201(7) and Section 6, 82-11-202(4):** The MBOGC currently provides the department with a list of all spacing units and pooling arrangements under consideration. The department's petroleum engineer reviews this list; identifies those that could have an impact on state land interests; and evaluates the potential impact for possible department action. In addition, the proponents of spacing units are already required by statute to provide direct notice to interest owners that are included in the proposal, including the department for state-owned lands.

| *Sponsor's Initials* | *Date* | *Budget Director's Initials* | *Date* |
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